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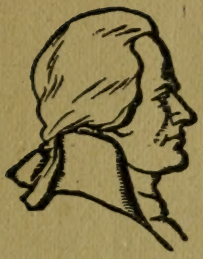
[Modern business Talks]

A CORPORATE VENTURE



MODERN BUSINESS
TALK No. 6

ALEXANDER HAMILTON INSTITUTE
NEW YORK

A Corporate Venture

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Number Six of a Series of Modern
Business Talks Prepared by the
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READING ASSIGNMENT

NUMBER SIX

"The corporation is a group of persons endowed by the state with certain rights. These rights may be enumerated and described, but . . . no enumeration and no description of rights can be so rigid as to be used. . . . as a defense of private or public offenses."—Pages 127-128, Chapter X, Volume 3 of the MODERN BUSINESS Text.

(1) Read this Talk on "A Corporate Venture." The corporate form of business, tho possessing decided advantages, frequently permits, by its very nature, the practice of fraud by directors and officers. This Talk illustrates such a case and points out how stockholders may protect themselves.

(2) Read from Chapter X to the end (pages 126 to 308) of "Organization and Control," which is Volume 3 of the MODERN BUSINESS Text.

(3) Study the situation described in Problem No. 3 and send in your solution for criticism.

If some men get more out of the twenty-four hours than others, it is usually because they put more into them. Amid the multitude of tasks that demand a part of our time, preference must be given to those that promise adequate returns. Viewed in that light, the claims of the MODERN BUSINESS Course upon your time—whether that be for thirty minutes a day or more—will be readily granted.

With the power of will, men master almost any situation. It is almost a crime to lack will-power.

—THE SILENT PARTNER.

A Corporate Venture

"The directors act in a fiduciary position. They must have a single eye to the interests of the company."—Page 228, Chapter XIV, Volume 3 of the MODERN BUSINESS Text.

Some years ago, the stockholders of a New York corporation, the Deeves-Udell Home and Development Company, were surprised to learn of certain irregularities in the conduct of the company's business. A meeting of stockholders was promptly called and a committee was appointed to examine the situation and to recommend measures for the proper protection of stockholders.

The investigation very forcibly brought home to the stockholders the fact that whereas they had been kept very well informed as to the number of lots sold, the prices obtained, the number of houses built and the amount of development work done, they knew nothing whatever of the internal management of the corporation in which they had invested their money.

They knew that William Deeves was president, that Robert Udell was secretary and treasurer, and that John J. Martin, the chief salesman of the old partnership firm of Deeves and Udell, had been made vice-president of the corporation; but that

was about as far as their knowledge went. Most of the stockholders had known the old real estate firm for years and had profited by its advice in real estate transactions. They had implicit confidence in the partners and readily joined them in their present venture—the development of a tract of land of approximately 1,000 acres, situated on Long Island.

An Attractive Proposition

It was the purpose of the company to divide this tract into building lots to be sold with or without improvements to homeseekers and investors on a deferred payment plan. The project appeared very attractive, and Deeves and Udell urged their clientele to take advantage of this opportunity for profitable investment.

At that time, Long Island was having a boom in real estate. The northward growth of New York City, which for years was encouraged by the inconveniences of ferry travel across the rivers both east and west, had been checked somewhat by the growing distances from Manhattan, while travel to Long Island had been facilitated by the building of additional bridges across the East River and by the boring of several tunnels under the river. The improved transit facilities were setting property values in Long Island climbing rapidly.

Before long, a change in the appearance of the landscape became noticeable. Old, slumbering villages took on the look and activity of suburban

developments. Attractive-looking railroad stations, with their well-sodded plots, neatly trimmed low hedges and freshly graveled drives, sprang up along the lines of travel and lent an air of solidity to the developments that were going on. Nearby were the artistic headquarters of the real estate agents whose white-vested salesmen met every incoming train and hustled prospective purchasers off in motor cars to newly developed residence parks with high-sounding names—the outlying farm lands of only a year before.

Plans and Specifications

The Deeves-Udell Home and Development Company was organized with a capital stock of $500,000. The purchase price of the tract of land to be developed was $200,000. After allowing for the necessary street and drive-ways, the tract, as mapped out, would yield about 10,000 building lots. The average cost per lot, 40 x 100, would therefore be $20.

The Udell Park Gardens—that was the name chosen for the tract—was to be a high-class development in every respect. All streets were to be macadamized, sidewalks and curbs would be of concrete; spaces between sidewalks and curbs were to be sodded and shade trees were to be planted. All lots would be terraced and each house would have water, gas and electricity. These improvements, it was estimated, would add approximately $200 to the cost of each lot. The average selling price per lot was placed at $600—a very conservative

figure as compared with other successful developments of Long Island real estate.

The project looked so favorable that in a short time the entire $400,000 capital stock that had been offered for sale was taken. A majority of the investors were former clients of Deeves and Udell, the real estate brokerage firm.

Getting Under Way

Things were now moving rapidly at Udell Park Gardens. Title to the land was obtained and development work was begun at once. A railroad station was already being erected near one corner of the property and a nearby large house was leased by the corporation at a yearly rental of $7,500, renovated and fitted up for use as an office building by the Orient Construction Company, the same company that was building the railroad station.

Following this, a contract was entered into with the Long Island Sidewalks and Paving Company for the laying of water and gas pipes and electric conduits; for the building of macadamized roads, cement sidewalks and curbs, for the planting of shade trees and for terracing the lots. The price per running foot, measured on both sides of the street at the lot line, was $19.87, each block to be paid for as soon as completed.

A contract was also made with the Orient Construction Company for the erection of ten houses of attractive semi-bungalow types at a contract price of $5,700 for each.

Now the company was ready to start making sales. The selling was to be conducted by Deeves and Udell who had an established sales force. The stockholders of the Deeves and Udell Development Company were also permitted to negotiate sales, and a commission of 6 per cent was to be paid on all sales negotiated by them.

Bonding the Property

Three months after the company began its operations, the board of directors authorized a $500,000 bond issue with interest at 6 per cent. This, it was explained, was to enable the development work to be pushed more rapidly, and to permit sidewalks and street work to be completed, if possible, before frost set in and so that selling could be resumed early next spring on a larger scale. Ten more houses were to be erected, as it was felt that even tho the first ten had not yet been sold, their presence had enhanced the value of the property generally. The bond issue was absorbed by the stockholders and by those who had bought building lots of the company.

Another three months showed marked progress. The railroad station was finished, street work, including sidewalks, shade trees, etc., was completed on nearly five miles of streets and avenues. Twenty houses had been erected, of which two were sold. More than eight hundred lots had been sold at an average price of nearly $900 each. The terms of sale were uniformly 10 per cent down and $15 per month for each lot.

But now occurred the event which led to the discovery and subsequent investigation of which mention was made in the beginning. It appears that at the time the corporate bonds were issued, the company had quietly borrowed on its notes $110,000 from two banks. The first of these notes, in the amount of $25,000 fell due. The secretary-treasurer requested an extension of time on this note, and this would undoubtedly have been granted had not suddenly a break occurred between Martin, the vice-president and his associates in power. Martin made some sensational accusations against Deeves and Udell, charging them with manipulating the Home and Development Company for their own benefit and against the interest of the stockholders and creditors. According to Martin, there had been a consistent "milking" of the company by means of various sharp practices.

When these rumors came to the ears of the bank, immediate payment of the note was demanded, and it was when the officers of the corporation were forced to admit their inability to meet this obligation, that the stockholders received the first proof that things were in a bad way.

The stockholders' committee, after ascertaining the facts, communicated with the banks in an effort to avert a judgment and an exposure. The committee agreed to take care of the notes as they fell due, the banks, in turn, promising to apply for the

appointment of the chairman of the committee as friendly receiver for the company.

A Series of Surprises

Now one thing after another was coming to light. The accountants who were put to work on the books found that the company had been manipulated in such a way as to drain it of all its cash resources just as quickly as they were acquired, and that if the officers had been permitted to continue undisturbed a little longer, no money would have been available, either for the redemption of the bonds or for the repayment of any part of the stockholders' investment.

The land for which the company had paid $200,000 had been bought from a young nephew of Udell's—evidently a mere figurehead. Already $50,000 had been paid on the purchase price and a mortgage for $150,000 had been given. The latter was what is known as a blanket mortgage, covering the entire tract and all improvements thereon. For each lot sold a release had to be obtained from the mortgagee by the payment of $20, by which amount the mortgage was then reduced.

It was positively ascertained that the whole tract had been bought in the nephew's name for $40,000. This purchase included, moreover, the house and lot near the station for which the company was paying a yearly rental of $7,500. That property had been separated from the rest of the tract and title to it had been retained by Udell's nephew.

The next discovery was that the Long Island Sidewalk and Paving Company had been merely a small jobbing concern until it was acquired by Deeves and Udell for a few hundred dollars. Evidently it had been bought by them for the purpose of contracting for the Deeves-Udell Home and Development Company for street development work in Udell Park Gardens. The contract price for this work was found to be unusually high in comparison with prices submitted by other contractors. Altogether, the Long Island Sidewalk and Paving Company had collected from the Deeves-Udell Home and Development Company the sum of $736,000.

The Orient Construction Company, which erected the station and the twenty houses, was likewise found to be owned by Deeves and Udell. That company had been paid in all $135,000 by the corporation.

As might be expected under the circumstances, there had been only lax supervision of the work of these companies. Already the roads were developing weak spots and here and there the sidewalks were showing defects. The houses were fairly well built, but it was estimated that they could have been built on a day's work plan at but little more than one-half of the price paid.

The work of surveying the tract had been given to Deeves' son, who was an architect. For staking out the streets he had collected a fee of $5,000.

For drawing plans for the station house and the twenty houses and for supervising their construction, he was paid a fee of five per cent of their total cost.

A Profitable Sales Contract

But perhaps the strangest feature of this remarkable undertaking was the contract entered into by Deeves-Udell Home and Development Company with the real estate firm of Deeves and Udell, according to which the selling of the corporation's property was to be carried out by the firm for a commission of thirty per cent. The books showed that the corporation was indebted to the firm in the sum of $101,060.80 for unpaid commissions. Under this contract, Deeves and Udell had earned in commissions $242,611.20. The contract further stipulated that all payments made by the buyers of lots were to be applied to these commissions until they were paid in full, with the exception of the $20 to be paid for release from the blanket mortgage. As fast, therefore, as the money had been paid in by the lot buyers, it had been paid out again in commissions to Deeves and Udell.

Laborers Worthy of Their Hire

The salary account, too, proved interesting to the investigating committee. The three directors and officers had done very well by themselves. Deeves had been voted a salary of $25,000 a year. Udell, for some reason, was satisfied with an annual stipend of a mere $12,000. Martin, tho he did absolutely

nothing for the corporation—merely directing the sale of lots for Deeves and Udell, in whose employ he was—likewise received, from the corporation, a salary of $12,000 a year.

Where the Money Had Gone

Various other irregularities came to light as the accountants and the stockholders' committee proceeded with their work. At first, investigators were puzzled as to where the money had gone that had been extracted from the corporation, but later it was learned that Deeves and Udell had become heavily involved in the erection of a number of costly apartment houses in Manhattan and that they were turning every penny of available cash into that enterprise.

The investigation was followed by a reorganization of the corporation whereby its management fell into other hands and whereby at length its affairs were placed on a sound financial basis. But the enterprise came within an inch of being wrecked.

Pointing a Moral

What now is the lesson to be learned from the foregoing narrative? That the corporate form of business is unsafe and therefore undesirable? That is hardly a legitimate conclusion, tho we do learn that the corporate form lends itself to manipulation and that unscrupulous officers sometimes take advantage of that fact. The present case illustrates three of the methods generally employed by dis-

honest officers, namely, (1) the voting themselves exorbitant salaries, (2) collusion in the making of contracts and frauds in marketing and in purchasing and, (3) formation of new companies for specially profitable business.

The moral pointed by the history of the Deeves-Udell Home and Development Company is that lack of knowledge with regard to the corporate form of doing business, including the rights and duties of officers, directors and stockholders, exposes participants in such an enterprise to the danger of losing their investment. Had the stockholders in this case possessed adequate knowledge of corporate practice, it is safe to say that they would have exercised their rights and that there would have been no manipulation.

The man who omits to acquire the necessary knowledge before he assumes financial responsibility, is in danger of gaining his experience at the cost of his capital.

Summary

The present reading assignment is devoted entirely to a study of the corporation, its nature, powers, management, etc. Inasmuch as the corporate form of organization is growing in favor with the business public, it is highly important that every business man should fully know its characteristics and be familiar with its operations. Chapter X relates the history and describes the nature and powers of

corporations. Chapter XI tells us how corporations are organized and discusses the factors that influence the choice of state in which to incorporate. These factors are not a few and should be duly noted. The manner in which corporations are dissolved is also described in that chapter.

Chapters XII to XIV contain a vast amount of valuable information with regard to stock, dividends, voting, proxies, stockholders' meetings, powers and liabilities of directors and officers. In fact, these chapters concisely cover the greater part of those subjects that relate to the operation and control of the corporation. Their importance, therefore, is evident.

In Chapter XV, under the title, "Intercorporate Relations," the author discusses various forms of combinations such as trade associations, pools and trusts. Usually, the terms "pool" and "trust" suggest illegal combinations. The pool aims to control output, divide the market among its members or otherwise regulate the profits. That both serve some useful economic purpose is not to be denied, as the author shows.

The last three chapters in the book are devoted to consolidations, holding companies and illegal combinations. Here, under various sub-titles, the author discusses a number of the questions that today agitate the minds of business men and legislators, and that in recent years have given the courts so much to do. In view of the practical bearing of these subjects upon present-day business enter-

prises, it is very desirable that we should know just what the law sanctions with regard to business combinations and what it frowns upon. These short chapters throw much light on that subject and are, moreover, decidedly readable.

> *The law aims to protect the weaker against oppression by the stronger and to regulate the exercise of that power which the possession of wealth confers. But legislation aimed at "big business" just because it is big, would prove more oppressive than the evils it sought to correct.*

"Intelligence is more than books and letters. It is knowledge of the forces of nature and the ingenuity to use them for human service."

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Modern business talks
Talk #6 (A corporate venture)

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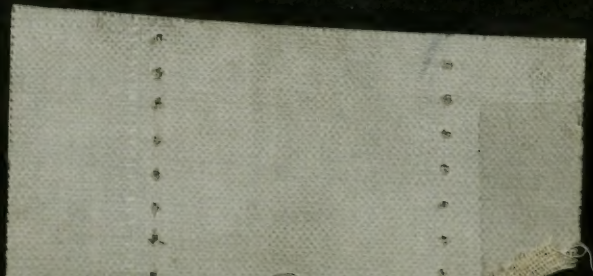

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